Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [redacted]:TL-N-4418-99
[redacted]

date: August 25, 1999

to: Chief, Examination Division, [redacted] District [redacted]

from: District Counsel, [redacted] District, [redacted]

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subject: [redacted]
Civil Settlement Payment

This memorandum has been prepared in response to your request for assistance and guidance from our office with respect to the deductibility of a $[redacted] payment pursuant to a settlement agreement with the Department of Justice. The memorandum is based upon the facts outlined below. If the factual statement is incorrect, please notify this office so that we may determine the effect, if any, on the advice rendered.

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

FACTS

The facts as we understand them are as follows:

During [redacted] and [redacted] [redacted] was under joint investigation by the Food and Drug Administration and the U.S.

Department of Justice in connection with the manufacture and sale of [redacted]. During [redacted] was [redacted] pled guilty to a variety of federal offenses and subsequently agreed to the payment of $[redacted] [redacted] a $[redacted] $[redacted].

The taxpayer did not deduct the criminal fine, but is deducting in full the $[redacted] civil settlement payment.

The civil settlement agreement in paragraph [redacted] indicates that the United States has or may have certain civil monetary causes of action against [redacted] predicated upon:

a) the False Claims Act, as amended, 31 U.S.C. §§ 3729-3733;
b) under common law;
c) the Federal Food, Drug and Cosmetics Act § 518, 21 U.S.C. § 360h; and
d) the Civil Monetary Penalties Law, 42 U.S.C. § 1320a-7a.

The settlement agreement in paragraph [redacted] indicates in part:

[redacted]

There is no allocation in the settlement agreement as to any dollar amount to the specific causes of action set forth in paragraph [redacted] of the settlement agreement. Additionally, there is no indication in the settlement agreement as to the characterization of the settlement payment as being compensatory or punitive in nature.

You want to know if any portion of the $[redacted] civil settlement could be disallowed under I.R.C. § 162(f).

DISCUSSION

We will provide you with a history and current Court treatment of the deductibility of settlements achieved pursuant to actions commenced under the False Claims Act (FCA), 31 U.S.C. §§ 3729-3631.

The FCA establishes a cause of action against persons making false claims upon the Unites States. The FCA in its present form allows the government to recover treble damages from those making

false claims or submitting false information in support of those claims. In addition, the United States is entitled to a $5,000-$10,000 penalty for each fraudulent submission, regardless of actual damage. To encourage action against defrauders, Congress authorized private citizens to bring civil actions against wrongdoers on the Government's behalf and to retain a portion of any recovery.

The issue involves the deductibility of what, in more general terms, are called fines and penalties.

The "public policy" doctrine was used by the Courts and the Service to disallow deductions for bribes, kickbacks and other illegal payments, fines and penalties, and certain other business expenditures. The courts have often held that taxpayers should be denied deductions for criminal or civil fines paid to a Government where the allowance of a deduction would frustrate sharply defined national or state policies proscribing particular types of conduct.

In the case of Deputy, et al. v. du Pont, 308 U.S. 488 (1940), the Supreme Court of the United States held that in order for a business expense to be deductible, for Federal income tax purposes, the expense must be both ordinary and necessary. And in the case of Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958), the Supreme Court stated that a finding of "necessity" cannot be made if allowance of the deduction would frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration of them.

The Tax Court initially adopted a fairly strict approach regarding the deductibility of fines and penalties pursuant to the FCA. In Faulk v. Commissioner, 26 T.C. 948 (1956) the court denied the deduction of a civil award payment under the FCA as the "allowance of the instant deduction would frustrate the sharply defined national policy proscribing the conduct of knowingly presenting false claims to the Government." Additionally, the Court rejected the taxpayer's argument that a deduction should be allowed for portion of the payment that might be considered compensatory in nature.

The Tax Court next considered the issue in Grossman v. Commissioner, 48 T.C. 15 (1967). The case involved certain payments made by the taxpayer in settlement of a suit brought under the FCA. Certain of the taxpayer's officers and stockholders had been convicted of criminally conspiring to supply inferior goods to the United States under a contract with the Navy. A civil action was later filed against the taxpayer claiming both compensatory and punitive damages. This action was settled and the payment in settlement was deducted by the taxpayer. The Court held that the

taxpayer was entitled to the deduction for the amounts paid to the Government in settlement of the claims brought under the FCA. In rejecting the Commissioner's argument that the allowance of the deduction would frustrate national policy, the Court focused on the nature of the particular payment and whether the payment was intended to be compensatory or punitive in effect. Because the settlement agreement specifically characterized the payment as damages of common law breach of contract, the Court concluded that the payments were intended to be compensatory and therefore deductible. Under the circumstances of that case the Court did not find it necessary to decide if a payment under the FCA generally is compensatory or punitive in nature.

The Tax Reform Act of 1969 amended Code section 162(a) by adding new section 162(f). That section states as follows:

> **(f) Fines and Penalties**
> No deduction shall be allowed under subsection (a) for any fine or similar penalty paid to a government for the violation of any law.

The effect of this new provision was both to codify the judicially created "public policy" doctrine and limit its application. In this regard, S. Rept. 91-552, at 274 (1969), 1963-3 C.B. 423, 597, states in pertinent part:

> The provision added by the committee amendments denies deductions for four types of expenditures: fines or similar penalties paid to a government for the violation of any law ... . The provision for the denial of the deduction for payments in these situations which are deemed to violate public policy is intended to be all inclusive. Public policy, in other circumstances, generally is not sufficiently clearly defined to justify the disallowance of deductions.

This position is now reflected in Treas. Reg. § 1.162-1(a) which states in pertinent part:

> A deduction for an expense paid or incurred after December 30, 1969, which would be otherwise allowable under section 162 shall not be denied on the grounds that allowance of such deduction would frustrate a sharply defined public policy.

Therefore, a deduction may be denied only under sections 162(c), (f), and (g), and the regulations thereunder.

The regulations for section 162(f) are contained in Treas.

Reg. § 1.162-21, Fines and penalties. The regulation states:

> (a) *In general.* No deduction shall be allowed under section 162(a) for any fine or similar penalty paid to -
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> (1) The government of the United States, a State, a territory or possession of the United States, the District of Columbia, or the Commonwealth of Puerto Rico;
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> (2) The government of a foreign country; or
>
> (3) A political subdivision of, or corporation or other entity serving as an agency or instrumentality of, any of the above.
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> (b) *Definition.* (1) For purposes of this section a fine or similar penalty includes an amount -
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> (i) Paid pursuant to conviction or plea of guilty or *nolo contendere* for a crime (felony or misdemeanor) in a criminal proceeding;
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> (ii) Paid as a civil penalty imposed by Federal, State, or local law, including additions to tax and additional amounts and assessable penalties imposed by chapter 68 of the Internal Revenue Code of 1954;
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> (iii) Paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal); or
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> (iv) Forfeited as collateral posted in connection with a proceeding which could result in imposition of such fine or penalty.
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> (2) The amount of a fine or penalty does not include legal fees and related expenses paid or incurred in the defense of a prosecution or civil action arising from a violation of the law imposing the fine or civil penalty, nor court costs assessed against the taxpayer, or stenographic and printing charges. Compensatory damages (including damages under section 4A of the Clayton Act (15 U.S.C. 15a), as amended) paid to a government do not constitute a fine or penalty.
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> (c) *Examples.* [omitted]

The term "fine or similar penalty" contained in section 162(f) has been interpreted by the courts to disallow a deduction for both criminal and civil penalties. *See* True v. United States, 894 F.2d 1197(10th Cir. 1990)(civil penalties imposed under Federal Water Pollution Act are nondeductible pursuant to I.R.C. § 162(f)(deterrent and retributive function similar to a criminal fine); Colt Industries, Inc. v. United States, 880 F.2d 1311 (Fed. Cir. 1989)(amount paid to settle a civil action brought by the Environmental Protection Agency seeking an injunction and imposition of civil penalties for the violation of the Clean Air Act and the Clean Water Act was held to constitute a nondeductible fine or similar penalty under I.R.C. § 162(f)); Adolph Meller

Company v. United States, 600 F.2d 1360 (Ct. Cl. 1979)(amount paid in settlement of actual or potential liability for a civil penalty under the Tariff Act of 1930 held nondeductible).

When confronted with an issue involving section 162(f) most courts have attempted to ascertain the purpose of the sanctions at issue. In Southern Pacific Transportation Co. v. Commissioner, 75 T.C. 497 (1980) the Tax Court was asked to interpret the term "similar penalty" in section 162(f). The court analyzed the Senate Finance Committee Report to the Revenue Act of 1971 (S. Rep. No 437, 92d Cong., 1st Sess. 73-74 (1971)) and concluded a civil penalty imposed for purposes of enforcing the law and as punishment for a violation thereof, is "similar" to a fine because it has the same purpose as a fine extracted under a criminal statute. The Tax Court has held that section 162(f) precludes deductions for civil penalties imposed for the purpose of enforcing law and as a punishment for a violation of the law. *See* Waldman v. Commissioner, 88 T.C. 1384 (1987), *aff'd* 850 F.2d 611 (9th Cir. 1988)(restitution paid pursuant to a criminal conviction is a nondeductible or similar penalty); Huff v. Commissioner, 80 T.C. (1983)(civil penalties imposed under California state law constituted "similar penalties" not deductible under section 162(f) because the penalties aimed to penalize defendants for their past illegal conduct and not to compensate an injured party).

A civil penalty imposed to encourage prompt compliance with a law, or as a remedial measure to compensate another party for expenses resulting from the violation, does not serve the same purpose of a criminal fine and has been held not to be "similar" within the meaning of section 162(f). In making this determination, the appropriate consideration is not the type of conduct which gives rise to the violation that results in the imposition of the sanctions, but the purpose that the sanction is to serve. *See* Mason and Dixon Lines, Inc. v. United States, 708 F.2d 1043 (6th Cir. 1983)(a trucking company was allowed to deduct "liquidated damages" assessed by Virginia for having operated some of its trucks in excess of the commonwealth's weigh limitations as the liquidated damages were determined to be compensatory in nature); S&B Restaurant, Inc. v. Commissioner, 73 T.C. 1226 (1980)(payments to Pennsylvania under its Clean Streams Act were not a "fine or similar penalty". Where law has a dual purpose, enforcement (nondeductible) and compensatory (deductible), the Tax Court held that it was its task to determine which purpose the payments in question were designed to serve); Middle Atlantic Distributors, Inc. v. Commissioner, 72 T.C. 1136 (1979)(settlement of violation of customs laws was characterized by parties as "liquidated damages". Court held that characterization of the payments as damages by the parties must be given effect and that the amounts in issue were not paid as a "fine or similar penalty").

In Talley Industries, Inc. v. Commissioner, T.C. Memo. 1994-608. *rev'd and rem'd* 116 F.3d 382 (9th Cir. 1997) the Tax Court granted summary judgment in favor of the taxpayer and permitted a deduction for all but $1,885 of a $2.5 million settlement paid as part of a plea agreement arising from the taxpayer's false claims on Navy contracts. The court found that the $1,885 was intended to compensate the Navy for the losses it sustained as the result of the taxpayer's conduct and concluded that the restitution falls within the literal terms of Treas. Reg. § 1.162-21(b)(1)(i); that is, it represents an amount paid pursuant to a plea of guilty for a crime. The court found that the remaining portion was deductible because the government did not intend it to be penal or punitive, but compensatory in nature. The Ninth Circuit, in Talley Industries, Inc. v. Commissioner, 116 F.3d 382 (9th Cir. 1997), reversed the Tax Court on this point indicating that there was a genuine issue of fact regarding the nature and purpose of the portion of the payments in excess of $1,885 and remanded the case for further proceeding. The retrial on this issue was held in June 1998 and no decision has been rendered to date.

Whether a civil penalty is deductible depends upon "the purpose which the statutory penalty is to serve." Talley Industries Inc. v. Commissioner, 116 F.3d 382, 385 (9th Cir. 1997), *citing* Southern Pacific Transportation Co. v. Commissioner, 75 T.C. 497 (1980). If the "payment ultimately serves each of these purposes, i.e., law enforcement (nondeductible) and compensation (deductible)," the court must "determine which purpose the payment was designed to serve." Waldman v. Commissioner, 88 T.C. at 1387-1388.

The following test determines whether a civil penalty falls within I.R.C. § 162(f):

> If a civil penalty is imposed for purposes of enforcing the law and as punishment for the violation thereof, [the payment is not deductible]. However, if the civil penalty is imposed to encourage prompt compliance with a requirement of the law, or as a remedial measure to compensate another party for expenses incurred as a result of the violation, it [is deductible because it] does not serve the same purpose as a criminal fine and is not "similar" to a fine within the meaning of section 162(f).

Talley Industries, 116 F.3d at 385-386, *citing* Southern Pacific, 75 T.C. at 652.

When Treas. Reg. § 1.162-21 was sent by the IRS to the Secretary of the Treasury for approval, the Commissioner included a

technical memorandum discussing the deductibility of payments under the FCA. This memorandum explains that only the portion of the payment under the FCA representing actual damages was intended to be deductible. The memorandum states, in pertinent part:

> The question has arisen as to the extent to which a taxpayer may deduct an amount paid to the United States pursuant to a judgment obtained or a settlement made as the result of an action [under the FCA]. That statute specifies that an individual engaging in a proscribed act must forfeit to the United States the amount of $2,000, and, in addition, pay to the United States double the amount of damages which the United States sustained as a result of that act, plus the costs of suit [1]. It seems clear that the $2,000 forfeiture is in the nature of a fine or similar penalty paid to the Federal Government and is therefore nondeductible; it also appears that the compensation paid to the United States for its actual damages is not such a fine or penalty, and is therefore deductible. There may be some question as to the proper treatment of the punitive damage portion of the payment; however, it is our position that, under the proposed regulations, such portion is nondeductible because it is a civil penalty imposed by Federal law and paid to the Federal Government.

Memorandum from the Commissioner to the Assistant Secretary for Tax Policy dated July 25, 1972, at 7-8, reprinted at 1972 TM Lexis 15, accompanying T.D. 7345, 37 Fed. Reg. 25936 (1972).

Technical memoranda such as the preceding are regulatory history that may be relied upon in determining the meaning of a regulation. Jewett v. Commissioner, 455 U.S. 305, 313-315 (1982). Moreover, an agency's construction of its own regulations is entitled to great weight. Udall v. Tallman, 380 U.S. 1, 16-17 (1965); Bowles v. Seminole Rock & Sand Co., 325 U.S. 410, 413-414 (1945). Clearly, the intent of the Service when it promulgated the applicable regulation was that double damages under the FCA would constitute a "fine or similar penalty" within the meaning of section 162(f).

The double damage provision of the FCA serves both

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[1] In the False Claims Amendments Acts of 1986, Congress expanded the FCA: (1) by extending liability to include those "who know, or have reason to know" that a claim is false, (2) by increasing the fixed statutory penalty for submitting a false claim from $2,000.00 to $10,000.00, and (3) by increasing the recoverable damages from double to treble the government's actual damages. False Claims Amendments Act of 1986, P.L. 99-562, 100 Stat. 3153.

compensatory and deterrence purposes. Talley Industries, 116 F.3d at 387; *c.f.* Grossman & Sons, Inc. v. Commissioner, 48 T.C. 15, 31 (1967) ("It . . . seems clear that the False Claims Act is at least partly remedial and compensatory in nature, although it may also be in part punitive.").

"[T]he double damages provision of the [FCA] is meant not only to compensate the government fully but also to deter fraudulent claims from being filed against it." United States v. McLeod, 721 F.2d 282, 285 (9th Cir. 1983); *see also* Mortgages, Inc. v. United States District Court for the District of Nevada, 934 F.2d 209, 213 (9th Cir. 1991); United States v. Northrop Corp., 59 F.3d 953, 965 (9th Cir. 1995). Congress chose the double damages provision "'to make sure that the government would be made completely whole.'" McLeod, 721 F.2d at 285 (quoting United States v. Hess, 317 U.S. 537, 551-52 (1943)). At the same time, however, the double damages provision "maximizes the deterrent impact...." of the FCA. McLeod, 721 F.2d at 285 (quoting United States v. Bornstein, 423 U.S. 303, 317 (1976)); *see also* United States v. Bausch & Lomb Optical Co., 131 F.2d 545, 547 (2d Cir. 1942), *aff'd by an equally divided court*, 320 U.S. 711 (1943)(describing the FCA as being "not only penal, but drastically penal.")

Moreover, because the Government can obtain double damages under the FCA only if the false claim is made knowingly, double damages are punitive. A liability directly dependent upon the culpability of the claimant "operates as a penalty" within the meaning of section 162(f). Duncan v. Commissioner, 68 F.3d 315, 318 (9th Cir. 1995). In Duncan, the taxpayers attempted to deduct, as a non-business bad debt, payments made to the IRS to satisfy their liability for the "responsible person" penalty set forth in section 6672. The Tax Court had held that the section 6672 penalties were not deductible because allowing such deductions would violate public policy.[2]

The Ninth Circuit affirmed the Tax Court's opinion, holding

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[2] Section 162(f) and similar provisions replace the violation of public policy as a reason for disallowing business expenses otherwise deductible under section 162(a). No such provisions explicitly apply to section § 166, governing the deductibility of non-business bad debts, which was the issue confronting the Duncan court.

Although Duncan does not address specifically section 162(f), Duncan addresses the same legal issue being considered here. The Duncan court applied the standard for disallowing deductions for frustrating public policy that was set forth in Tank Truck Rentals v. Commissioner, 356 U.S. 30, 35 (1958). Tank Truck Rentals is described and approved in the legislative history behind I.R.C. § 162(f). S. Rep. No. 552, 91st Cong., 1st Sess. 273-275 (1969), 1969-3 C.B. 423, 596-598.

that the responsible person penalty was not deductible because such a deduction would violate public policy. Id. at 317, 318. Section 6672 creates a penalty distinct from the underlying tax obligation "that would not exist unless the taxpayers had been responsible for a "willful" violation of the law." Id. at 318. Similarly, double damages under the FCA only can be obtained if the Government can show culpability on the part of the violator, in that there was a "knowing" violation. The double damages portion of the FCA, like the responsible person penalty, is a fine or similar penalty within the meaning of I.R.C. § 162(f).

The Government's settlement of FCA damages is not limited in any way by the Government's actual losses. Double damages are not entirely compensatory, and can serve as a penalty depending on the intent of the parties.

Under the FCA, a person must pay twice the amount of the actual damages sustained by the Government. Violators of the FCA must pay double damages regardless of the Government's actual expenses of investigating the violation, regardless of the length of time between the violation and the Government's recovery, and regardless of the amount, if any, of any incidental damages to the Government.

As related above, the double damages imposed by the FCA bear the indicia of a penal measure and therefore is a fine or similar penalty within the meaning of I.R.C. § 162(f). The double damages need not bear any relation to the Government's actual losses. Double damages may only be recovered upon a showing of culpability on the part of the violator. Additionally, the history of the Treasury Regulations show that double damages under the FCA are a "fine or similar penalty" within the meaning of I.R.C. § 162(f).

Notwithstanding the above, the courts have often looked to the understanding between the parties in making the determination as to the nature of the payment when a settlement is brokered. In Grossman, 48 T.C. at 31, the Court held that the entire amount paid by the taxpayers to satisfy their liability under the FCA was deductible.[3]

The taxpayers in Grossman, however, had made a settlement offer in which the payment was characterized as *solely* representing damages under general contract law, which the Government accepted

[3] Although the court addressed the issue in terms of the general "public policy" analysis in effect prior to the enactment of I.R.C. § 162(f), the court analyzed the intent of the parties with respect to the payment to determine if the purpose was remedial or penal, as is required in current case determinations.

without change. Id. at 31. As the court noted, the taxpayers

> very carefully worded their settlement offer so the amount to be paid would represent damages resulting from a purported common law breach of contract, that they were willing to compromise the Government's claims only as an ordinary and necessary expense of conducting their business, that the Attorney General accepted their offer without modification in this respect, and that the terms of the settlement agreement therefore characterized the nature of the payment for tax as well as for other purposes.

Grossman, 48 T.C. at 28.

In Middle Atlantic Distributors, Inc. V, Commissioner, supra, the court stated:

> It is clear throughout the settlement negotiations between petitioner and the United States, as well as in the settlement document itself, that petitioner was offering to make only a settlement payment representing liquidated damages. It is equally clear that, when the United States accepted petitioner's offer in settlement, it accepted the settlement as "liquidated damages". We conclude, therefore, that at all relevant times during the settlement negotiations, the United States was attempting to recover, and subsequently recovered, only reimbursement for lost revenues and damages. Obviously, such an intent by the Government does not comport with an attempt to punish or deter. We conclude that the amounts at issue herein were not paid as a "fine or similar penalty." ... Once again, we conclude that the characterization of the payment as damages by the parties must be given effect.

In Rev. Rul. 80-334, 1980-2 C.B. 61 it was held that payments made to the United States Treasury by the taxpayer as a result of a consent order entered into by the taxpayer and the Department of Energy does not come within the provisions of section 162(f) of the Code. The consent order specifically stated that the Department of Energy had determined that the imposition of civil or criminal penalties would be inappropriate, and that such penalties would not be sought from the taxpayer with respect to the period covered by the order.

Finally, in Talley Industries, Inc. v. Commissioner, 116 F.3d 382 (9th Cir. 1997) the court states:

> Because the double damage provision has both compensatory and deterrence purposes, whether the portion is deductible depends

> on the "purpose the ... payment was designed to serve." ... Neither the characterization nor purpose of the payment is clarified by the settlement agreement. That agreement is ambiguous. The ambiguity may be resolved, however, by determining the intent of the parties. That intent presents a factual issue for the trier-of-fact.

The reconsideration of the Talley case was decided in Talley Industries v. Commissioner, T.C. Memo. 1999-200. Judge Panuthos first stated the general rule with respect to deductions claimed by a taxpayer:

> Deductions are a matter of legislative grace, and the taxpayer must show that he comes squarely within the terms of the law conferring the benefit sought. *See* Rule 142(a); INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934); Welch v. Helvering, 290 U.S. 111, 115 (1933). Applying this principle in the instant case, petitioner bears the burden of proving that, in settling the Stencel matter, the parties intended for the entire $2.5 million payment (including the $940,000 portion of the payment that exceeded the Government's $1.56 million "singles" damages) to represent compensation to the Government for its losses.

The court acknowledged that the settlement agreement did not characterize the $2.5 million payment, or any part of it, as double damages. In light of that ambiguity, the direction by the Court of Appeals was that the deductibility the excess over $1.56 million would be resolved by determining the intent of the parties.

Judge Panuthos indicated:

> A settlement agreement is treated like any other contract for purposes of interpretation. *See* United Commercial Ins. Serv., Inc. v. Paymaster Corp., 962 F.2d 853, 856 (9th Cir. 1992); *see also* Saigh v. Commissioner, 26 T.C. 171, 177 (1956); Fisher v. Commissioner, T.C. Memo. 1994-434. In the case of an ambiguous contract, the Court may consider extrinsic evidence, such as evidence of the parties' prior negotiations and communications, in order to ascertain the parties' intent. *See* California Pac. Bank v. SBA, 557 F.2d 218, 222 (9th Cir. 1977); 2 Restatement, Contracts 2d, sec. 214(c) (1981); *see also* United Commercial Ins. Serv., Inc. v. Paymaster Corp., supra at 856; Interpublic Group of Cos. v. On Mark Engg. Co., 381 F.2d 29, 32- 33 (9th Cir. 1967).

The court reviewed the documents reflecting the negotiations of the parties leading up to the settlement agreement and determined that the parties intended the settlement to include double damages under the FCA. A review of the parties' various offers and counteroffers repeatedly referred to the settlement as including double damages. However, the parties executed a settlement agreement that was silent on the subject of the characterization of the settlement payment.

The final outcome determined by Judge Panuthos was as follows:

> The Court of Appeals emphasized that petitioner "suffers the consequence" if evidence to establish entitlement to the disputed deduction is lacking. Talley Indus., Inc. & Consol. Subs. v. Commissioner, 116 F.3d at 387-388. The record shows that the parties did not agree whether the portion of the settlement in excess of the Government's "singles" damages would constitute compensation to the Government for its losses or a penalty against Stencel. It thus follows that petitioner has failed to establish entitlement to a deduction for the disputed portion of the settlement.

Thus, in a case like yours, where the settlement agreement is neutral with respect to the characterization of the payments, the Service will have to secure the underlying correspondence between the taxpayer and the Department of Justice to ferret out the intent of the parties in entering into the settlement.

The above discussion on the FCA would apply to the other causes of action that have been settled in this matter. It appears that payments that would be made under the Federal Food, Drug and Cosmetics Act § 518, 21 U.S.C. § 360h would be compensatory in nature; but payments under the Civil Monetary Penalties Law, 42 U.S.C. § 1320a-7a could include penalties and compensatory assessments.

CONCLUSION

To begin, you will have to try and ascertain if there was a determination of the compensatory damages to the government in this matter. To the extent that the $[redacted] civil settlement payment exceeds the compensatory damages to the government, a further inquiry will have to be made.

You will have to try and establish some kind of allocation of the $[redacted] to the various causes of action and then determine the intent of the parties in entering the settlement.

The starting point will be to contact the Department of Justice attorneys, [redacted] and [redacted] who brokered the civil settlement agreement and secure any and all correspondence that discusses the understanding between the parties in reaching the ultimate settlement. Both of these attorneys work out of the United States Attorney Office for the District of [redacted]. The telephone number for that office is [redacted].

If you have any questions or need further information, please contact [redacted] at [redacted].

/s/
[redacted]
Assistant District Counsel

NOTED:

/s/
[redacted]
District Counsel

cc: [redacted]
Examination Group [redacted]